JUNE/JULY 2016

DEVOTED TO LEADERS IN THE INTELLECTUAL PROPERTY AND ENTERTAINMENT COMMUNITY

VOLUME 36 • NUMBER 6

THE Licensing Journal

Edited by Gregory J. Battersby and Charles W. Grimes

Wolters Kluwer

Praxis

Franchising

Bruno Floriani and Marissa Carnevale

Surprise! Franchisors May Be Unable to Rely on Enforceable Non-Compete Covenants

Most franchise agreements contain a non-compete clause that prevents a franchisee from competing with the franchised business for a certain period after the end of the franchise relationship. These provisions generally are meant to ensure that the franchisee does not continue to use the resources and know-how obtained during the course of the franchise relationship in a manner that would lead to unfair competition with respect to the franchisor or other franchisees.

Non-compete covenants take various forms and the Canadian courts have not hesitated to enforce them in circumstances where they seek to protect a franchisor's legitimate interests or those of its franchised system, provided that they do not unduly restrict a franchisee's potential to make a living after parting ways with the franchised business. In other words, if a non-compete covenant does not provide for overreaching protections in scope and time, the covenant typically will be enforced.

In a February 29, 2016 decision, *MEDIchair LP v. DME Medequip Inc.* [2016 ONCA 168], the Ontario Court of Appeal refused to enforce a franchisee's non-compete covenant because the evidence demonstrated that the franchisor did not intend to open a franchised store within the restricted territory. The court concluded that non-compete covenants must protect "the legitimate interest of the franchisor," but cannot extend beyond that. In this case the franchisee had de-identified its franchise and opened a similar business in the same location; however, because the franchisor did not intend to operate in the protected territory after the franchise relationship ended, the franchisor was found not to have the requisite legitimate interest to restrict competition by the franchisee within that territory. In so holding, the court overturned the lower court's decision maintaining the enforceability of the non-compete provision.

Decision

The franchisor operates a franchised network of locations that sell and lease home medical equipment and the franchisee had a franchise located in Peterborough, Ontario (a relatively small town) for approximately 20 years.

The franchise agreement contained a non-compete covenant preventing the franchisee from directly or indirectly operating a "similar business" for 18 months after the franchise relationship ended, within 30 miles of the franchisee's store or any other store using the same franchise system.

After the franchise agreement expired, the franchisee removed the franchisor-branded signage and commenced operating an identical business under a different name from the same premises, which led the franchisor to apply to enforce the franchisee's non-compete covenant by seeking injunctive relief. The franchisor succeeded before the trial court, where the judge found the non-compete covenant to be enforceable and the franchisee to be in breach. Noting that it was not relevant whether the franchisor intended to open a new franchise within the restricted territory, the trial judge emphasized instead the importance of preserving the franchise system's integrity and the parties' compliance with their contractual undertakings, particularly considering the potential adverse impact on the franchise system if certain franchisees were unexpectedly released of their non-compete covenants.

The appeal court overturned this decision and refused to enforce the restrictive covenant on the basis that, while its temporal and territorial scope were not unreasonable in the abstract, the franchisor no longer had the additional requisite "legitimate interest" in circumstances where it had no intention of operating a competing store in the protected geographic area. The court noted that "by deciding not to operate in Peterborough, [the franchisor] effectively acknowledged that it has no legitimate or proprietary interest to protect within the defined territorial scope of the covenant" [*MEDIchair LP v. DME Medequip, Inc.*, 2016 ONCA 168 at para 47] and, perhaps more importantly, concluded as follows:

> the clause has not been struck down as generally

> unreasonable or unenforceable. It is not ambiguous, nor are the temporal or territorial boundaries unreasonably broad. However, the restrictive covenant is unreasonable as between these two parties in the circumstances of the particular Peterborough franchise because [the franchisor] does not have a legitimate or proprietary interest to protect within the territorial scope of the covenant. [*MEDIchair LP v. DME Medequip, Inc.*, 2016 ONCA 168 at para 52.]

The appeal court refused to overturn the trial court's finding in *MEDIchair LP v. DME Medequip Inc.* [2015 ONSC 3718], that the non-compete covenant could not be considered unenforceable by reason of being ambiguous simply because the scope of activities restricted was described as activities "similar to" those of the franchised business. This suggests that courts will tend to give meaning to a restriction on "similar business" activities insofar as the activities of a particular franchise system can be determined with sufficient clarity.

Comment

This decision may be evidence of a growing trend, as the Ontario Court of Appeal's findings are not dissimilar to the Superior Court of Quebec's findings in *Groupe Sportscene Inc. v. 2639-6564 Quebec Inc*. [2013 QCCS 17], in which a franchisor was denied its application for preliminary injunctive relief as it was unable to demonstrate its intent to open a franchised location in the same town where the former franchisee had continued operating a similar business after the franchise relationship ended. While that case was not heard on the merits, the franchisor's failure to demonstrate its specific "interests" in the particular geographic area that was covered by the franchisee's non-compete covenant led to the court's finding that the franchisor's application, at the very least, presented no urgency.

This trend may not be of particular interest when a franchisor intends to continue operating within the areas protected by restrictive covenants undertaken by its franchisees. However, franchisors must consider whether they may face resistance in enforcing non-compete covenants against franchisees in circumstances where they are experiencing uncertainty as to their continued presence in a given market or are contemplating downsizing their franchise network, as these factors may have a significant impact on what is considered to form part of the franchisor's legitimate interests as they relate to the non-compete covenants of its franchisees.

In addition, going forward, courts may well limit the enforceability of restrictive covenants based on an assessment of additional (and perhaps unknown) surrounding factors and considerations that affect the franchisor's legitimate interests at the time enforcement is sought, notwithstanding the fact that a covenant may otherwise be found to be reasonable and unambiguous in principle.

Franchisors should bear these principles in mind as they elaborate concrete business and development plans and implement franchisee recruitment initiatives, as these elements ultimately may be determinative with respect to their intentions and the legitimate interests of their networks in certain geographic areas. Moreover, franchisors must consider carefully whether the enforcement of any given franchisee's non-compete covenants may be affected by their specific actions during the franchise relationship.

Bruno Floriani is a leading practitioner in business law, with a particular focus on franchise, distribution, licensing, and technology. For over 30 years, he has advised a wide range of clients, from large corporations and public companies to SMEs, in various industries including retail, hospitality, manufacturing, professional services, and IT. Bruno has broad experience in structuring complex licensing, supply, franchising and joint venture arrangements, including advising foreign companies with respect to their entry into the Canadian market and continued compliance with Canadian law.

Marissa Carnevale has extensive experience in franchising, licensing, distribution, and technology matters, and regularly advises businesses of all sizes in such matters, as well as related fields including e-commerce, intellectual property, advertising, privacy, anti-spam, and social media. She specializes in negotiating and drafting complex legal agreements relating to licensing, franchising, distribution and technology, at both the domestic and international levels.

This article was first published in the International Law Office Franchising Newsletter—www.internationallawoffice.com.